AMERICAN ACADEMY *of* ACTUARIES

October 8, 2013

Via email to: eyeung@naic.org

Nicole Elliott
Chair, Property/Casualty Risk-Based Capital (E) Working Group

David Altmaier
Interim Chair, Catastrophe Risk (E) Subgroup

c/o Eva Yeung, Senior Insurance Reporting Analyst
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Reinsurance Association of America Discussion Draft

Dear Nicole and David:

The Property/Casualty (P/C) Risk-Based Capital (RBC) Committee of the American Academy of Actuaries[1] (Committee) has reviewed the August 21, 2013 "Discussion Draft—a Proposal for Revising the P&C R3 RBC Factors for Reinsurance Credit Risk" issued by the Reinsurance Association of America (RAA) and exposed by the P/C RBC Working Group of the National Association of Insurance Commissioners (NAIC). The Committee is pleased to provide the NAIC with the following feedback on the RAA discussion draft.[2]

A number of elements of the RAA discussion draft are consistent with our Committee's April 2013 Report on Reinsurance Credit Risk Charge in the NAIC Property/Casualty Risk-Based Capital.[3] Other aspects of the RAA discussion draft are not clearly consistent with the RBC Committee's April 2013 report. The Committee's comments on selected aspects of the RAA discussion draft are presented below.

---

[1] The American Academy of Actuaries is a 17,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

[2] The Committee is particularly indebted to the following individuals for their work in drafting this response: Saeeda Behbahany, Neil Bodoff, Joe Cofield, Robert Eramo, Allan Kaufman, and Alex Krutov.

[3] Reinsurance Credit Risk Charge in the NAIC Property/Casualty Risk-Based Capital, American Academy of Actuaries' Property/Casualty Risk-Based Capital Committee's Report to the NAIC, April 2013, available at http://actuary.org/files/Report_to_PC_RBC_WG_on_Reinsurance_Credit_Risk_in_RBC_3.29.13.pdf.

1. Reinsurance Credit Risk in R6 and R7

The RAA discussion draft states that the 10 percent factor currently applicable to reinsurance recoverables[4] "should be decoupled from CAT Risk (R6 and R7)." The Committee agrees that the factor to be used in the proposed R6 and R7 charges should not mirror the factor applied to reinsurance recoverables in RBC. It is our understanding that, in the calculation of the contingent credit risk element of the proposed catastrophe risk charges, the NAIC is currently using a 10 percent factor on a provisional basis.[5]

There are many reasons not to use the same factor. First, the current 10 percent charge is applied to expected ceded claims and ceded unearned premium. The same 10 percent charge should not be applied to modeled one-in-100-year ceded claims, which is one of the categories included in the R6 and R7 calculation.

Second, changing the RBC formula to adequately and separately reflect catastrophe risk will readily allow for an assessment of reinsurance credit risk for catastrophe reinsurance separate from the assessment of reinsurance credit risk for other types of reinsurance.

The RAA proposes that an alternative factor should be applied, and the Committee agrees that an alternative, non-zero factor is necessary. At this time, the Committee is not recommending a specific size for the factor.

2. Variation by Reinsurance Company

The RAA discussion draft proposes that the reinsurance risk charge vary based on the credit strength of the reinsurance company. The Committee agrees that, to the extent that the reinsurance risk charge relates to credit default risk, variation in RBC charge based on reinsurer credit strength is reasonable. The Committee's April 2013 Report discusses considering reinsurer claims-paying ability in quantifying the counterparty default risk component of the overall reinsurance risk.

The RAA discussion draft proposes that the charge for the counterparty default component of the reinsurance risk be calculated by using factors described as "S&P Reinsurance Recoverable Credit Risk Charge (A rated Cedent)." However, factors used by rating agencies are not always appropriate for use within the current NAIC RBC framework. Rating agencies collect and

[4] We avoid using the "10% R3 factor" language of the RAA discussion draft because the 10 percent charge is usually split between the R3 and R4 charges in the current NAIC RBC formula.

[5] We understand that the NAIC's intent is to maintain consistency with the general reinsurance risk charge in RBC in the sense that the reinsurance-related element of the proposed catastrophe charge reflects the same level of risk.

analyze important information unavailable for use in the NAIC RBC formula and have the ability to make qualitative adjustments to ratings.[6]

The RAA discussion draft proposes that the total reinsurance risk charge be calculated as three times[7] the charge for the counterparty default component of the overall reinsurance risk. This "three-times charge" would not be an appropriate means by which to capture the total reinsurance risk. The issues of commutation risk, reinsurance dispute risk (including liquidity implications[8]), extent of risk transfer, and extent of reinsurance use (including related leverage[9] of the reinsurance risk) have limited, if any, relationship to the credit quality of either the ceding company or the reinsurer. The credit quality of the reinsurer, however measured, is unlikely to be the best base for determining the reinsurance risk charge for anything other than counterparty default risk.

3. Magnitude of Risk Charge

The RAA discussion draft makes the case that the 10 percent charge for reinsurance risk is too high and provides a brief report of the financial condition of the reinsurance industry since 2000 to support its case. However, the financial condition of the reinsurance industry does not necessarily affect all of the elements of the risk charge that were identified in the Committee's April 2013 Report, and the financial condition alone of the reinsurance industry cannot support a conclusion that the 10 percent charge is too high either for a specific reinsurer or for the reinsurance industry in general.

The RAA discussion draft also characterizes its alternative "three-times charge" as conservative based on the view that "…the primary risk associated with recoverable is the default risk..."[10] The RAA discussion draft does not provide a foundation for these statements. We cannot agree that the factor of 3—or any other factor, for that matter—is appropriate because some elements of the reinsurance risk are not dependent on the size of its counterparty default risk component.

---

[6] A recent publication by A.M. Best (*A.M. Best Methodology – Understanding BCAR for Property/Casualty Insurers*, March 25, 2013) describes the treatment of reinsurance risk in its rating methodology the following way: "A.M. Best's capital model, which starts with a fixed 10% charge for nonaffiliated reinsurance recoverables, allows the analyst to assign variable risk charges based on a reinsurer's Best's Rating, which can range from a low of 2% for an A++ (Superior) reinsurer to charges in excess of 50% for suspect reinsurers.… The 100% risk charge for unrated reinsurers may be reduced if adequate additional information is provided to A.M. Best."

In addition, the charge could be further increased for companies that are "excessively dependent on unaffiliated and foreign-affiliated reinsurance...." Qualitatively-based additional adjustment to ratings can also be made by rating agencies.

[7] The factor of three becomes one for non-rated reinsurers in cases where the "S&P Reinsurance Recoverable Credit Risk Charge (A rated Cedent)" factor [charge] is 23 percent. (The S&P's factor for non-rated reinsurers is 33.1 percent, but the RAA discussion draft caps it at 23 percent.) This Committee has not evaluated the impact of applying no adjustment factor to that group of reinsurers.

[8] Liquidity issues will arise from disputes, but they may also arise in other aspects of reinsurance credit risk. It is our understanding that some regulators identify a lack of liquidity resulting from delays in reinsurance recoveries as a major contributor to some insurance insolvencies.

[9] Leverage will be most apparent when there is high reinsurance usage, but it may also arise in other aspects of reinsurance credit risk.

[10] This Committee has not reviewed the RAA's calculation.

4. Treatment of Collateral

The RAA discussion draft states that there should be a net reduction in RBC amounts when collateral is posted for reinsurance recoverables. The Committee agrees that, to the extent that the reinsurance credit risk charge relates to counterparty default risk, the creation of some offset in RBC amounts, given collateral, is reasonable.

However, the collateral must offset the risk, not the RBC charge or expected losses. An offset to risk is most easily determined when the range of amounts that might be due from the reinsurer is clear. It is not clear how the RAA discussion draft might address this point. Furthermore, the appropriate RBC offset for collateral is complex because, in addition to counterparty default risk, the reinsurance risk charge takes into consideration other risk components, including commutation risk, reinsurance dispute risk, extent of reinsurance transfer, and the extent of reinsurance use. It is unclear that collateral reduces the level of all of the reinsurance risk components and, if so, what the degree of this reduction might be. That said, the collateral issue might be more easily addressed for catastrophe reinsurance credit risk than for the risks of other types of reinsurance.

We would be pleased to discuss this topic further. If you have any questions about this feedback, please feel free to contact Lauren Pachman, the Academy's casualty policy analyst, at pachman@actuary.org.

Sincerely,

Alex Krutov, FCAS, MAAA, ASA, CERA
Chairperson, P/C Risk-Based Capital Committee
American Academy of Actuaries